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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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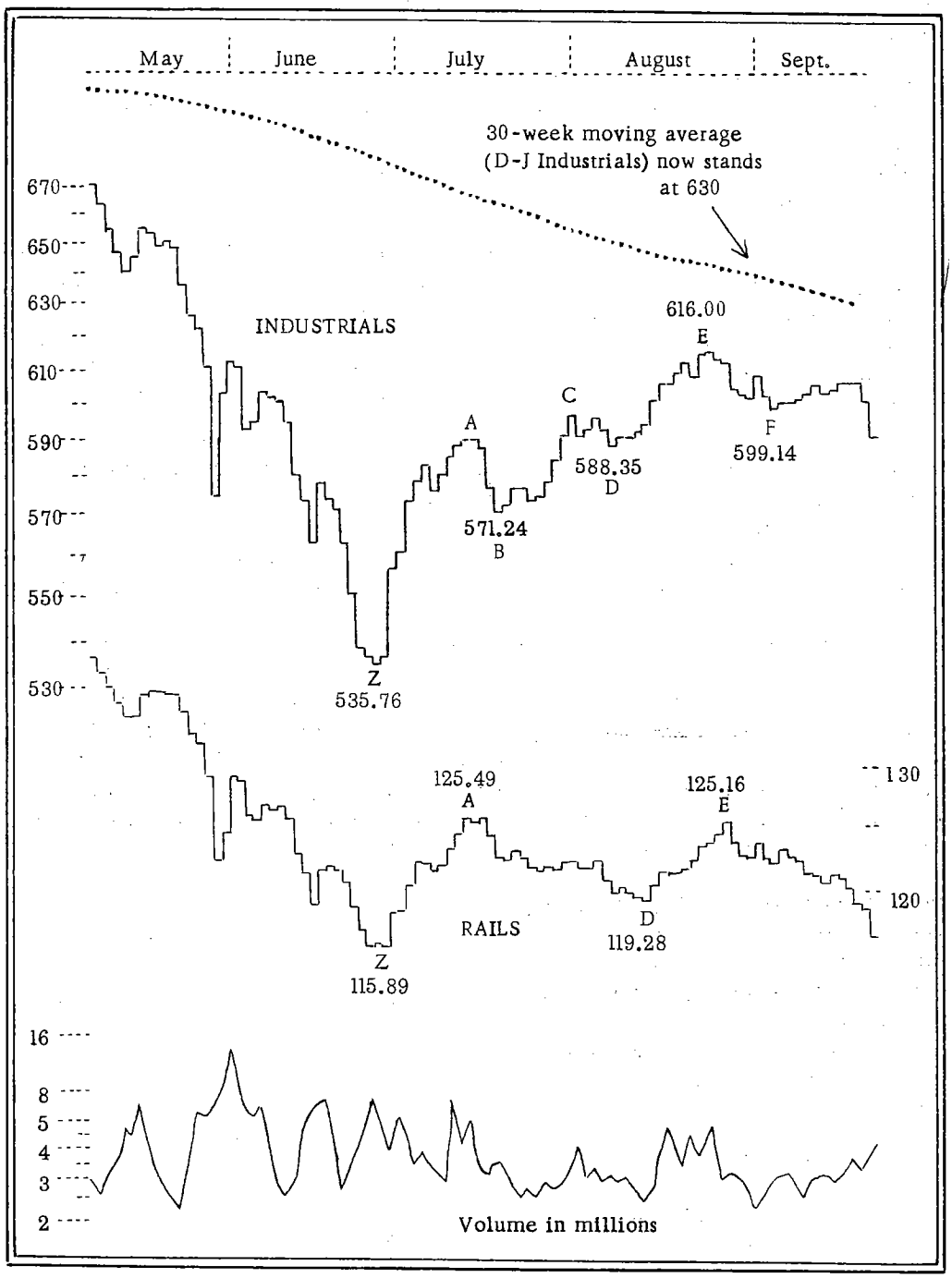
From my seat on the West Coast, the rise which began on June 26, 1962, still appears to be a correction following a bear market crash. In the last two Letters (192 and 193) I stated that "the secondary trend is probably in the process of turning down." I remain of that opinion.

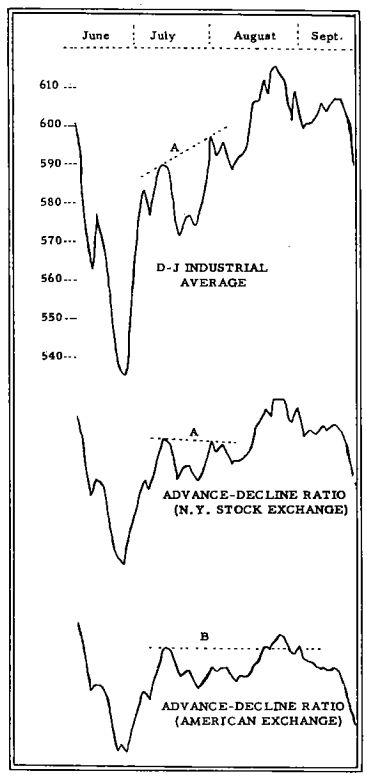
The last confirmed highs for the rise which began June 26 occurred on July 12 (A on chart), when Industrials touched 590.27 and Rails hit 125.49. The decline which followed took Industrials to 571.24 (B), Rails to 119.28 (D). The next advance saw Industrials rally to a new recovery high of 616.00 (E), but this move was unconfirmed by Rails. Having failed by 33¢ at point E to better their July 12 peak, the Rails turned down. Last week (September 19) Rails broke below D to their lowest level since June. Two days later (Sept. 21) Industrials broke below their first decline point of 599.14 (F).



Thus, on the rise from B Rails failed to confirm Industrials, and on the decline from E Rails broke below their preceding low (D). The Rail Average is obviously showing outstanding weakness, and the action of Industrials on Sept. 21 was the first indication that Industrials are beginning to follow the lead of the Rails.

The lowest levels struck by the Averages following the July 12 (last confirmed) highs were 119.28 on Rails and 571.24 on Industrials. Since Rails have already violated their 119.28 point, a comparable Industrial penetration (and full downside confirmation) would require a breaking of the 571.24 level. Obviously, the breaking of point F (599.14) by Industrials was ominous, and if point D (588.35) is violated next the picture will appear even more

ominous. (Nevertheless, a full confirmation of Rail weakness would entail an Industrial violation of 571.24). Another unpleasant aspect of the recent action is the downward zig-zag shown on both the American Exchange and N.Y.S.E. advance-decline ratios (see chart). The first sign of weakness in the breadth-price relationship occurred during July when Industrials and the A-D ratio diverged (trend-lines marked A on chart). The A-D ratio subsequently confirmed by rising to a recovery high, but again the ratio turned sluggish, and on September 20 the A-D ratio zig-zagged down and broke to its lowest level since mid-August. At the same time, the American A-D ratio dropped well below its July 12 peak (trendline B), a discouraging performance. The majority of stocks, it would appear, do not want to follow the Industrial Average to recovery highs, and such action must be considered negative.



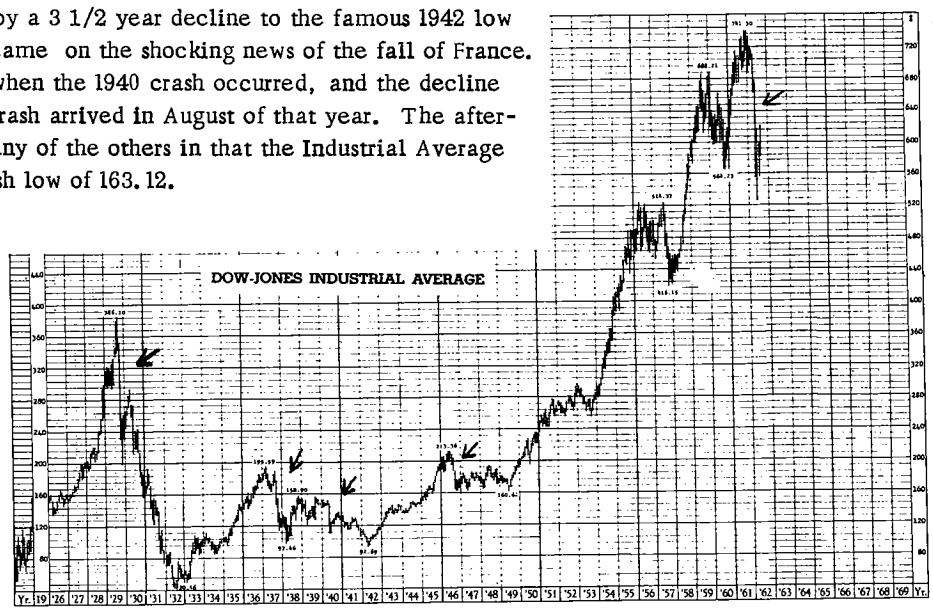
If the secondary (upward) correction has ended -- and I believe it has -- this in itself does not imply a direct collapse to new bear market lows. For instance, following the great post-crash rally of 1930 (which ended in April), Industrials dropped from an April high of 294 to a June low of 211. A second rally extended into September of 1930, and it was not until late September that the Industrial Average finally plunged through its 1929 bear market low of 198. Thus, although the secondary rise actually ended in April, 1930, new bear market lows were not forthcoming until September -- five months later.

Again, following the crash of September, 1937, the market rallied irregularly from the September, 1937 low of 113 to a January, 1938 recovery peak of 134. From that point a sharp decline took Industrials back to 118 in February (5 points above the 1937 low). A second rally extended into late February, and it was not until March of 1938 that the 1937 bear market lows were violated.

CONCLUSION: The series of divergent movements in Industrials, Rails and the A-D ratio following the June 26-July 12 rise should be taken bearishly (particularly in view of the fact that the primary trend is down). I now classify all three trends (primary, secondary and minor) as bearish. Nevertheless, subscribers should bear this thought in mind: While it is probable that the 1962 crash-recovery is over, there could be another drop (now in progress), and then another partial recovery prior to a final penetration of the 1962 lows. In other words, it is not at all unusual, subsequent to the termination of the secondary recovery, to have a confusing series of price movements before new bear market lows are finally established.

WHAT'S AHEAD? Letter 193 discussed "crash" action in the market and the patterns which have usually followed those crashes. I have included a monthly chart (from M.C. Horsey, 37 Wall Street, N.Y.C.) showing the path of the Industrial Average since 1926. Since 1926 there have been five concentrated downward movements, each lasting only a month to two months. Each of these movements was characterized by (1) extreme rapidity, (2) great violence, (3) demoralized selling and lack of bids, (4) heavy downside volume. The five periods are 1929, 1937, 1940, 1946, 1962.

The 1929 crash was followed by three years of further drastic decline. The 1937 period was followed by six months of decline to a new low in early 1938. A rise into late 1938 retraced 62% of the 1937 decline (Rhea considered this to be a new bull market). The late-1938 rise was followed by a 3 1/2 year decline to the famous 1942 low close of 92.92. The crash of May, 1940 came on the shocking news of the fall of France. Stocks were already in a major bear trend when the 1940 crash occurred, and the decline did not end until April, 1942. The 1946 crash arrived in August of that year. The aftermath of the 1946 affair was different from any of the others in that the Industrial Average never sank substantially below the 1946 crash low of 163.12.



In other words, the best or most hopeful action following any crash in modern history came following the 1946 crash. For three years (following August, 1946) the Industrial Average fluctuated between 163 and 193 -- until June, 1949, when the senior average hit its final low of 161.60.

I have made a careful study of the behavior of individual stocks during and following periods of crash action. The question I have constantly asked myself

is "Can crash action be written off as a mistake or a temporary and harmless reappraisal?" My conclusion is that a true crash is never a mistake. Such action represents massive liquidation. Concentrated liquidation is almost always followed (in due time) by lower prices in the majority of stocks (if not in the Averages as well).

Because 1946 was the mildest of the five crashes (and its aftermath may represent the best we can now hope for), it might be well to study the action of a few individual stocks during that period. I have reproduced four representative charts (arithmetic-monthlies) from F. W. Stephens' "Graphic Charts".

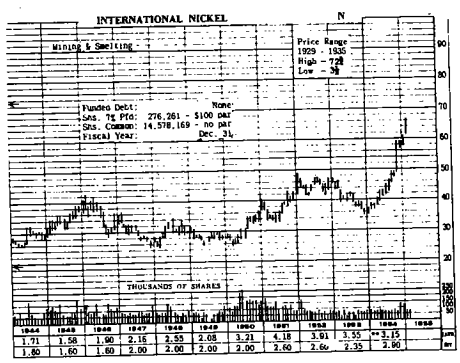
"Blue chip" International Nickel put on a fair performance in 1946 (relative to other stocks). Nickel skidded from 42 to 29, then rallied to 37 in 1947. In 1947 it broke to a new low of 25, then rallied to 34 in late 1948. The 1949 low for Nickel was above the 1948 low (although the Averages touched bottom in 1949). In retrospect we can see that the 1947-49 action constituted a base for Nickel. In 1950 the stock "took off." Note that Nickel's chart did not portray true crash (liquidating) action during 1946, and its post-1946 action was consequently better than that seen in the majority of stocks.

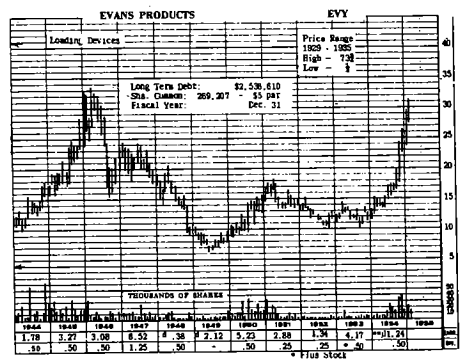
Evans Products' performance was quite different and more typical. The stock crashed from a high of 33 to a low of 15 in 1946. The rise in 1947 carried Evans to 24, following which the stock declined (punctuated by the sharp 1948 rally) to the 1949 low of 6. Evans "bottomed" with the Averages, and by 1955 the stock had quintupled.

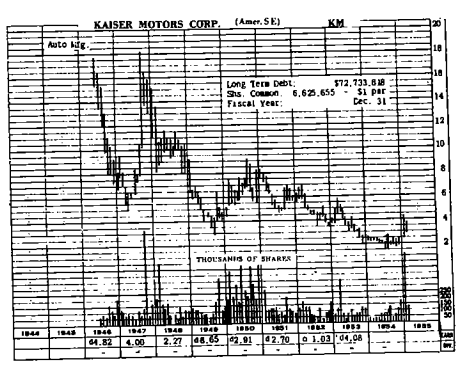
Kaiser Motors (now defunct) showed extraordinary action during 1946-49 (I remember because I owned it!) The stock was a famous "new issue" in 1946 ("General Motors -- Watch out!") Kaiser promptly fell from 17 to 7 during the 1946 crash, and to 5 in 1947. It then rose to a new high (above the 1946 high) in 1947! (Not one in a hundred stocks rose above their '46 high in '47, and this illustrated the old adage that stocks can do anything). From the 1947 high, Kaiser broke to 3 in 1949. In 1954 the stock fell below 2. Those who held Kaiser in the early 1950's remember the 1946 crash well.

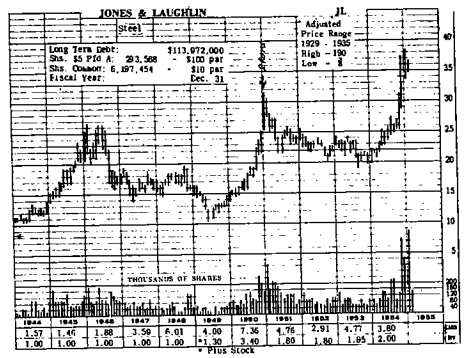
Jones and Laughlin might be called the typical 1946-49 cyclical stock. Crash liquidation drove JL from 25 to 16 in 1946. The stock broke below 14 in 1947, rose to 19 in 1948, and finally dropped to a bear market low of 10 1/2 in 1949. Between 1949 and late 1950 (the bull market began in mid-1949), JL tripled in price.

What is to be learned from these four examples? First, we have studied the action of three typical issues and one new issue during the mildest crash and post-crash period of modern times. Yet in that period most stocks had a difficult time of it. (1) Those stocks that suffered the most violent liquidation during the 1946 crash were the worst performers over the next few years. (2) In the majority of cases, a long period was required following the crash before major bottoms were formed and completed. Most stocks did not hit lows until 1949. (3) Stocks that seemed to escape the 1946 crash-liquidation formed bases early, while some few stocks did not fall appreciably below their 1946 crash level lows. (4) During the period from 1946 to 1949, although the Industrial Average dropped only 24% (212 to 161), many stocks suffered severe and protracted collapses. (5) During 1946 to 1949, the price-earnings ratio on the Dow Industrial Average dropped from 20.1 to 7.1! During the same period average yields on the Dow Average rose from 3.2% to 6.9%! (6) Stocks returned to values in 1949, and those investors who took the 1946 crash seriously had the cash to buy "bargains" at a major bottom (1949). (7) Most stocks fluctuated widely during 1946-49. On balance, however, I doubt if more than a handful of people made money during that period.









COMPARISON: The charts of many, many stocks portray the extraordinary liquidation which occurred during the 1962 crash period. Such liquidation cannot be dismissed lightly. The aftermath of periods of crash action is usually lower prices and business contraction. Even the mild 1946-49 period (which did not contain a major depression) proved a difficult one for investors. The odds now favor lower prices (in due time) and an extended period of reaccumulation before stocks are ready to embark on a

major bull move again. During the forthcoming period, investors will need all the knowledge and patience they can command.

LATE NOTES (written Monday, Sept. 24, 1 P.M. N.Y. time). On Friday (Sept. 21) the market finally got fully "in gear" (on the downside) as Industrials sagged a whopping 9.87 points, Rails .91, and volume expanded to 4.2 million shares, the highest volume in a month. Sig nificantly, new lows rose to 58, the greatest number since June 27 -- at which time the Industrial Average was 537. Thus the technical weakness (which has been building up for many weeks) finally made itself apparent for all to see.

Today the market opened sharply lower, and by the second hour the Industrials were below point D (588.35 -- see page 1). While corrective rallies are assured following such violent downside action, the back of the recovery movement has obviously been broken.

ANNOUNCEMENT Sloan Wilson's book, "Public Participation in the Stock Market" has been purchased by many of my subscribers. Dr. Wilson has brought his fascinating credit-debit studies up to date and has agreed to send photocopies of his latest work to interested parties for a price of $1.00. Write to Dr. Sloan Wilson, 5618 West 62nd St., Mission, Kansas (send one dollar).

STOCKS 33 out of 346 representative stocks are now holding above their 30-week moving averages, a decline of 1 since last week, but still a pitifully small percentage (less than 10%).

Recent Letters have drawn attention to the weakness ("wedges", "fanlines", diminishing upside volume, unimpressive "breakouts") in the majority of stocks on the Exchange. Significantly, many "bullish" charts have not worked out well on the rally, but during the decline of the past few days the weak stocks have shown plenty of downside "follow-through".

I have included a chart of Royal McBee covering the years 1950 to date (montly chart by M.C. Horsey). This chart illustrates typical post-crash action. RMB crashed in 1957, and the force of the crash suggested that RMB's bull market was over. The subsequent collapse in RMB is evident on the chart. In the majority of cases, such violent crash action in an individual stock suggests (1) that the momentum of the initial violent downmove will carry the stock much lower, or (2) at best, a long base of accumulation is needed before the stock can start a major rise again. The 1962 drop set off crash-action in some of the nation's leading growth stocks. Thus, the monthly charts of Proctor & Gamble, Reynolds Tobacco and IBM (to mention a few) suggest that they will see much lower prices or long periods of consolidation (or both) before these stocks ever approach their 1962 peak area again. These three charts are visual proof of the shattering of the "growth" theory (a theory which has been almost a religion on Wall Street for the past few years). Readers might compare these current charts with the charts of the '46 crash on page 3.

Shorts can be put out by speculators at this time, but I suggest waiting for a rally that goes dull. The following are offered as suggestions: Weakest stock groups at this time are steels, tobaccos, food chains, papers, rails, office equipment and rubbers. Individual stocks which appear particularly weak are IBM, Addressograph, National Cash Register, Underwook, Goodrich, U.S. Rubber, Armco Steel, Republic Steel, U.S. Steel, A & P, Grand Union, Kennecott, Lone Star Cement, Amer. Tobacco, Phillip Morris.